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Reports Doubted On Japanese Bank Debt

Concerns about the financial condition of Japanese banks remain high among domestic and foreign analysts despite reassuring statistics and statements from Japanese government and bank spokespersons. The recent data, in fact, have aggravated rather than salved these worries. Because banks play a critical role in economic activity, uncertainty about their health has cast another shadow over Japan's already cloudy economic outlook.

In an effort to quell rumors — generated primarily by the weak stock and real estate markets — about the stability of the Japanese banking system the Ministry of Finance took the unprecedented step in late April of releasing aggregate figures on the profits of top banks in the year ended March 31 as well as data on the amount of loans in arrears (see *JEI Report* No. 17B, May 1, 1992). MOF calculated that the country's 11 nationwide commercial banks, seven trust banks and three long-term credit banks held bad loans (those on which no interest payments had been made for more than six months as of the end of FY 1991) totaling a maximum of ¥8 trillion ($59.3 billion at ¥135=$1.00). This amounted to about 2.4 percent of the banks' total outstanding loans of ¥340 trillion ($2.5 trillion). MOF and Bank of Japan officials have pointed out that the 11 nationwide commercial banks added ¥344.1 billion ($2.5 billion) to their loan-loss reserves during the April 1991-March 1992 period — nearly five times the ¥69.4 billion ($514.1 million) they put aside in the previous fiscal year. That set-aside brought their total bad loan reserves to ¥647 billion ($4.8 billion), according to MOF, while the top 21 banks' bad debt reserves had reached ¥2.3 trillion ($17 billion) at the end of FY 1991. In addition, the Finance Ministry asserted that the banks' stock portfolios contained unrealized profits

worth ¥10.8 trillion ($80 billion) as of March 31. This amount would provide an adequate cushion if all nonperforming loans fell into default, MOF authorities suggested.

Private estimates of nonperforming bank loans had been running as high as ¥30 trillion ($222.2 billion) until an internal BOJ analysis was leaked in late May. According to press reports, BOJ calculated the loan arrears faced by Japan's 21 largest banks at ¥26.4 trillion to ¥35.4 trillion ($195.6 billion to $262.2 billion) as of the end of March. The entire banking system, these reports said, carried between ¥42 trillion and ¥56 trillion ($311.1 billion and $414.8 billion) in nonperforming assets. Even if BOJ's figures are off by as much as one-half, Japanese banks obviously are ill-prepared to cover the debt.

The situation may be even worse. During the stock and real estate booms of the late 1980s many banks created nonbank financial subsidiaries and backed their loans. These subsidiaries were freer to participate in the rampant speculation than their parent banks. With both stock market and real estate prices down sharply from their boom levels, these nonbank subsidiaries have watched their problem loans multiply with frightening speed. According to a recently released MOF survey of 300 nonbank firms (not all associated with banks), more than 15 percent of the nonbanks reported bad loans at the end of 1991 valued three to five times higher than the year before; a shocking 47 percent experienced bad debt increases of more than fivefold. According to a private research company, 19 nonbanks affiliated with commercial banks were saddled with ¥233.5 billion ($1.7 billion) worth of bad debts as of May 31. A February MOF study of housing loan companies revealed equally disturbing news. Each of the eight companies queried had from ¥20 billion to ¥40 billion ($148.1 million to $296.3 million) worth of loans in arrears; loans on which no interest had been paid for more than a year topped ¥200 billion ($1.5 billion). Since many of these nonbanks are poorly capitalized, analysts are concerned that the commercial banks backing them will be liable for their bad loans.

Not only does it appear that commercial banks may be liable for nonbank debts but they also may be expected to bail out or absorb financially insolvent smaller banks and other financial institutions. Analysts fear that the case of Toyo Shinkin Bank Ltd. will become a model for resolving future bank failures (see *JEI Report* No. 18B, May 8, 1992). In this case MOF cajoled Sanwa Bank, Ltd. and Industrial Bank of Japan, Ltd. into bearing a large part of Toyo Shinkin's debts. Sanwa assumed ¥80 billion ($592.6 million) of Toyo Shinkin's ¥252 billion ($1.9 billion) worth of liabilities. For its part IBJ forgave 70 percent of its loans to Toyo Shinkin, and an IBJ affiliate wrote off 42 percent of the loans it had made. In addition, IBJ will provide ¥50 billion ($370.4 million) worth of low interest loans to Sanwa over the next several years.

Some large commercial banks also are bracing for the fallout from a series of loan fraud scandals that occurred last year. Besides setting aside more money for bad debts, the 11 nationwide commercial banks lifted so-called specific reserves from ¥492 billion ($3.6 billion) to ¥836 billion ($6.2 billion) in FY 1991 to cover potential losses and damage claims arising from the scandals.

All together, analysts fear, these potential liabilities will decimate bank profits; they also could drain both bank and government reserves established to cover bad debts. Even if MOF's conservative ¥8 trillion ($59.3 billion) bad debt figure is correct, economists predict it will take at least five years for banks to work their way out from under this burden. If BOJ's ¥56 trillion ($414.8 billion) figure is closer to the truth, however, Japanese bank profits could take quite a while to recover. With such a gloomy outlook, it is not surprising that bank stocks have led the Tokyo stock market's decline since the beginning of this year.

The uncertain situation facing major Japanese banks has focused new attention on policies dictating the preparation for bad debts, their disclosure and their classification. When real estate and stock prices were rising, Japanese banks' use of latent real estate and stock profits to back new lending was seen as a competitive strength. Now that land and stock prices are falling, the practice is considered a threat. Falling prices for both types of assets have led many analysts to question the

Japan's Foreign Direct Investment by Country, FY 1987-FY 1991

(in millions of dollars)

	FY 1987	FY 1988	FY 1989	FY 1990	FY 1991	Cumulative March 31, 1992
United States	$14,704	$21,701	$32,540	$26,128	$18,026	$148,554
Canada	653	626	1,362	1,064	797	6,454
North America	15,357	22,328	33,902	27,192	18,823	155,008
United Kingdom	2,473	3,956	5,239	6,806	3,588	26,186
Netherlands	829	2,359	4,547	2,744	1,960	14,776
Luxembourg	1,764	657	654	224	266	5,873
West Germany	403	409	1,083	1,242	1,115	5,805
France	330	463	1,135	1,257	817	4,973
Switzerland	224	454	397	666	62	2,558
Spain	283	161	501	320	378	2,245
Belgium	70	164	326	367	222	1,941
Italy	59	108	314	217	322	1,222
Ireland	58	42	133	49	102	716
Europe	6,576	9,116	14,808	14,294	9,371	68,636
Indonesia	545	586	631	1,105	1,193	12,733
Hong Kong	1,072	1,662	1,898	1,785	925	10,775
Singapore	494	747	1,902	840	613	7,168
Thailand	250	859	1,276	1,154	807	5,229
South Korea	647	483	606	284	260	4,398
Malaysia	163	387	673	725	880	4,111
China	1,226	296	438	349	579	3,402
Taiwan	367	372	494	446	405	3,136
Philippines	72	134	202	258	203	1,783
Asia	4,868	5,569	8,238	7,054	5,936	53,455
Panama	2,305	1,712	2,044	1,342	1,557	17,801
Caymans	1,197	2,609	1,658	588	158	7,489
Brazil	229	510	349	615	171	6,731
Bahamas	734	737	620	121	103	3,562
Mexico	28	87	36	168	193	2,067
Bermuda	36	337	228	360	232	1,810
Virgin Islands	38	133	118	15	614	918
Netherlands Antilles	199	172	38	9	---	795
Peru	1	---	---	---	---	696
Latin America	4,816	6,428	5,238	3,628	3,337	43,821
Australia	1,222	2,413	4,256	3,669	2,550	18,613
New Zealand	121	117	101	231	236	1,161
Oceania	1,413	2,669	4,618	4,166	3,278	21,376
Liberia	267	648	643	531	707	5,539
Africa	272	653	671	551	748	6,574
Kuwait	54	20	32	26	26	1,467
Iran	---	1	1	---	1	1,007
Middle East	62	259	66	27	90	3,522
Total	33,364	47,022	67,540	56,911	41,584	352,392

Source: Ministry of Finance

Japan's Foreign Direct Investment by Sector, FY 1987-FY 1991

(in millions of dollars)

	FY 1987	FY 1988	FY 1989	FY 1990	FY 1991	Cumulative March 31, 1992
Manufacturing Sector	$7,832	$13,805	$16,284	$15,486	$12,311	$93,924
Food Products	328	419	1,300	821	632	4,717
Textiles	206	317	533	796	616	4,615
Wood and Paper Products	317	604	555	314	312	3,280
Chemicals	910	1,292	2,109	2,292	1,602	12,542
Metals	786	1,367	1,591	1,047	907	11,215
Nonelectric Machinery	687	1,432	1,762	1,454	1,284	9,216
Electric Machinery	2,421	3,041	4,480	5,684	2,296	22,656
Transport Equipment	1,473	1,281	2,053	1,872	1,996	12,877
Other	703	4,051	1,901	1,207	2,666	12,804
Nonmanufacturing Sector	25,080	32,634	50,517	40,620	28,809	251,946
Agriculture and Forestry	97	162	151	153	276	1,635
Fisheries	44	94	47	61	72	810
Mining	511	1,013	1,262	1,328	1,003	17,542
Construction	87	309	646	300	420	2,809
Trade and Sales	2,269	3,204	5,148	6,156	5,247	36,564
Banking, Finance and Insurance	10,673	13,104	15,395	8,047	4,972	70,290
Services	2,780	3,732	10,616	11,292	5,413	40,079
Transportation	2,145	2,372	2,927	2,169	2,489	19,927
Real Estate	5,428	8,641	14,143	11,107	8,899	54,748
Other	1,047	3	180	8	10	7,533
Branch Offices	452	584	739	806	464	5,928
Other Transactions*	---	---	---	---	---	595
Total	33,364	47,022	67,540	56,911	41,584	352,392

*Certain overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.